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SUBJECT: Foreign Banks: Optimistic About Profits, but Face Hurdles

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Business Sensitive

¶1. (U) SUMMARY: Fierce competition from Chinese banks, a constantly changing regulatory environment, and difficulties in working with Chinese shareholders are the key challenges confronted by local government and foreign bankers in south China. Despite their concerns, the foreign banking community remains optimistic about profitability and future reforms. END SUMMARY

Regulatory Hurdles

¶2. (SBU) Banking officials report that foreign banks face a variety of regulatory challenges that do not apply to locally-incorporated foreign backs, Chinese banks, or to joint ventures with Chinese banks. For example, foreign banks are allowed to open any number of sub-branches but each bank is only permitted a single branch in each city. Moreover, each sub-branch requires an approval process that takes at least three months. The bankers noted positively that foreign banks can now offer credit card services and RMB-based financial services to Chinese residents and institutions. However, Bank of America's Guangzhou Branch Manager Julia Yu said that foreign bank branches may only conduct RMB business with individuals who make a term deposit in excess of RMB 1 million (roughly UDS 132,000), a not inconsiderable sum. Domestic banks have no such requirement.

¶3. (SBU) Milson Lau, General Manager of Guangzhou Branch, Citibank (China) Company, told us that some directives from the Chinese Banking Regulatory Commission (CBRC) were so unclear that he was forced to seek CBRC advice to ensure full compliance. Lau noted that domestic banks were more flexible than their foreign counterparts in interpreting and following CBRC directives, even to the extent of skirting around inconvenient requirements. He lamented that this unfair competition had led to customer complaints and lost business when foreign banks attempted to comply fully with CBRC requirements. Yu added that foreign banks find it difficult to keep track of the constantly changing regulations, amendments, and new interpretations of the law. She believes frequent regulatory changes increase the risk of non-compliance by foreign banks.

¶4. (SBU) Yu also complained that certain regulations may appear beneficial to foreign banks on paper, but in reality they are restrictive. She cited as an example a circular issued by the State Administration of Foreign Exchange (SAFE) requiring foreign banks to reduce foreign debt balances to 60 percent of the 2004 quota. Yu pointed out that although Chinese banks must reduce their foreign debt to 30 percent of the 2004 quota, domestic banks still have the advantage of large deposits to support loans. In contrast, her branch relies heavily on borrowing from overseas banks to support loans. SAFE's method of determining the foreign debt quota, in her

view, was unfair to foreign banks.

Local Shareholder Woes

¶5. (SBU) Commenting on shareholder relations, Guangdong Development Bank (GDB) Deputy President Daniel Massey specifically said that shareholders not fulfilling contractual obligations and their interfering in day-to-day operations as the two biggest problems. According to Massey, China Life -- one of the major shareholders of Guangdong Development Bank -- causes him the most trouble. He said that China Life requested that eight senior management staff from Citigroup quit and be compensated by GDB; this was clearly against contract terms. Regarding day-to-day operation, Massey gave examples of the GDB Chairman using party connections, unions, and the company's structure to thwart Citigroup's attempts to bring GDB in line with international banking standards. In the past, the chairman of GDB had denied Citigroup access to GDB's scoring model for its credit card business by declaring it to be proprietary information and a "state secret." In another instance, he used the Party to directly threaten two local staff working closely with Massey on corporate management risk. Moreover, when the chairman is not playing a direct role, GDB branches act like individual fiefdoms, with a Party-appointed general manager in absolute control of each.

CBRC Can Be Helpful

¶6. (SBU) On a positive note, both Lau and Yu provided examples of how the CBRC had become more professional and helpful over time. Lau said the approval procedure for Citibank's incorporation was amazingly smooth and fast due to the CBRC's help in obtaining the "flexibility" of ten other official bureaus. He believes this

demonstrated China's willingness to liberalize the banking sector. Yu said the CBRC showed professionalism and efficiency in the review and approval of her branch's RMB retail business. CBRC officials made a site visit to ensure that equipment was in place, the staff was well trained, and to solicit feedback from the bank.

Domestic Banks Are Competitive

¶7. (SBU) Lau described domestic banks' branch networks as "strong," and added that four of the five big publicly-traded banks had improved their corporate governance and made their lending more accountable. Both Lau and Yu agreed that domestic banks are keen to learn and adopt modern practices from foreign banks. Yu said that China Construction Bank is following Bank of America's model of functional management, which has staff report directly to the product manager, rather than to the branch manager. Both Lau and Yu believe that domestic banks currently face reduced government pressure to lend for policy projects.

A Profitable Future in Chinese Banking

¶8. (SBU) Despite the current difficulties, the foreign bankers all were optimistic about doing business in China. Yu, whose branch hopes to hit 50 percent annual growth this year, said that given China's double-digit GDP growth, it is hard to find a bank that is losing money.

CBRC: Agriculture Bank Next in Line for Reform

¶9. (SBU) Deputy Director General of CBRC's Guangdong Office Meng Jianbo cautioned that some banking experts believe China is opening up too fast. To maintain rapid and healthy development of the banking sector, he said that reform of China's Agriculture Bank would be CBRC's next focus. In the future the Agriculture Bank will mainly serve the countryside, farmers, and the agricultural sector. The CBRC also plans to support micro-finance to small workshops, plantations, farms and to other small- and medium-sized businesses

by providing guidance to banks, offering favorable tax policies for SME loans, and implementing an improved accountability system.

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